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Federal Communications Commission  
Office of Secretary

April 15, 1997

EX PARTE

Mr. William F. Caton  
Secretary  
Federal Communications Commission  
1919 M Street, NW, Room 222  
Washington, D.C. 20554

Re: Written Ex Parte  
CC Docket No. 96-262

Dear Mr. Caton:

During the ex parte meeting on March 5, 1997, FCC staff requested information regarding the depreciation practices of AT&T. Attached hereto is a paper prepared by Jeffrey H. Rohlfis titled "History of AT&T's Depreciation Practices" in response to the FCC's request.

The original and a copy of this written ex parte are being filed in the Office of the Secretary on April 15, 1997. Please include it in the record of the above-referenced proceeding.

Respectfully submitted,

A handwritten signature in cursive script that reads "Linda Kent".

Linda Kent  
Associate General Counsel

Attachment  
cc: Ken Moran  
Wade Herriman  
Thomas David  
Andy Mulitz

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## History of AT&T's Depreciation Practices

Jeffrey H. Rohlfs

April 15, 1997

This paper is submitted in response to requests for information by personnel of the Federal Communications Commission (FCC). The requests were made at *ex parte* meetings on March 5, 1997. The meetings included several Commission personnel, several representatives of the local exchange industry, and me. The topic of discussion was depreciation practices of the local exchange industry. During the discussion, comparisons were made between the depreciation practices of local exchange carriers (LECs) and those of AT&T. FCC personnel asked for further information on this issue, with regard to financial reporting, as well as regulatory reporting.

Table 1 shows information on AT&T's accounting practices. The table includes regulatory data from *Statistics of Communications Common Carriers* and financial data from AT&T's 10-K annual reports. Data are shown from 1984 (the first year after divestiture) through 1994 (the last year for which AT&T reported the regulatory data). The regulatory and financial data are not directly comparable, because the financial data include unregulated activities; *e.g.*, the operations of AT&T Technologies. Nevertheless, the data show salient features of the various depreciation accounts.

At the end of 1983, AT&T revalued its assets for financial reporting on a basis appropriate for unregulated industries. Thus, all the 10-K data in Table 1 are stated on an unregulated basis. In conjunction with this revaluation of assets, AT&T reported an extraordinary charge of \$5.5 billion (after taxes). This charge was taken against (the old) AT&T's 1983 income in financial reports. The offset to this charge did not reduce AT&T's gross plant, but instead, was recorded as an increase to the accumulated depreciation reserve on AT&T's financial books. This reduced AT&T's net plant value down to its economic value. It had no effect on cash flow.

This change in financial reporting also had no effect on the regulatory books of either the new AT&T or the Bell Operating Companies. Financial reporting rules require asset values on a company's books to not exceed economic value. In contrast, regulated books are based on original cost less the accrued depreciation allowed by regulators. In addition, much of the extraordinary charge related to the reevaluation of terminal equipment. That equipment had been transferred at net book value to AT&T's unregulated operations. AT&T believed that the economic value of the equipment was far less than net book value.

Some ten years later, LECs underwent the same sort of accounting change that AT&T underwent in 1983. As a result, LECs reported substantial extraordinary charges that were offsets to income (on financial reports) in the year charged. As in AT&T's asset reevaluation, these charges were not reflected on the companies' regulatory books and did not affect cash flow.

After divestiture, AT&T's depreciation remained subject to regulation. Allowed depreciation prior to 1988 was inadequate to reflect declines in economic value. The plant of AT&T Communications, at that time, consisted (and still consists) largely of switching and transmission equipment. Our analysis in *The Depreciation Shortfall*<sup>1</sup> adduces evidence that the rate of economic depreciation for such plant exceeds 10 percent per year.

Nevertheless, AT&T's regulatory depreciation rate in 1985 was only 8.6 percent. The regulatory depreciation rate increased to 9.5 percent in 1988. Even so, however, the 1988 rate still fell short of reflecting annual declines in economic value. Furthermore, no progress was made in having regulatory books recognize the inadequate regulatory depreciation of the past.

The seriousness of AT&T's capital recovery problem was dramatically exposed when AT&T took another extraordinary charge of \$ 6.7 billion (after taxes) on its financial books in 1988, similar to the charge it took in 1983. This charge applied primarily to analog equipment, which by 1988 had become obsolete and virtually worthless. Nevertheless, at that time, analog equipment was carried at substantial values on AT&T's books. After the extraordinary charge, AT&T's financial records

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<sup>1</sup> J. Rohlfs, C. Jackson and R. Richardson, *The Depreciation Shortfall* prepared for submission before the Federal Communications Commission, CC Docket No. 96-262: *USTA Comments*, Attachment 15, filed January 29, 1997; *Reply Comments*, filed February 13, 1997.

reflected the decline in economic value of analog equipment. However, as in 1983, there was no adjustment of AT&T's regulatory books in 1988.

In 1989, the FCC decided to use price-cap regulation for AT&T. Also, starting in that year AT&T was allowed to substantially increase its regulatory depreciation expense by approximately \$1 billion per year to deal with the decline in value of AT&T's analog equipment. During 1989 to 1991, AT&T's regulatory depreciation rate averaged 13.0 percent — an increase of 36 percent over the 1988 level.

The increase in capital recovery during the 1989-1991 period was substantially less than the 1988 extraordinary charge (especially considering that depreciation expense is pre-tax). Nevertheless, by 1992, AT&T's regulated depreciation decreased to approximately the 1988 level. However, AT&T apparently realized that the 1992-1993 rate (an average of 9.9 percent) was too slow to reflect declines in economic values. By 1993, its depreciation rate declined and its earnings increased. AT&T had previously petitioned the FCC to use financial depreciation on its regulated books. The FCC allowed AT&T broad latitude under the price-cap carrier option of the FCC's new depreciation simplification rules in 1993.<sup>2</sup> This allowed AT&T to increase its depreciation expense in 1994.

A key point to note is that the X factor in AT&T's price-cap plan was set sufficiently low that AT&T could fund its *de facto* amortization program and still have satisfactory earnings. Indeed, AT&T's average earnings for 1989 to 1991 exceeded the cost of capital of 12.75 percent that the Commission had previously determined. Thus, the combination of an appropriately low X factor and flexibility in setting depreciation rates allowed AT&T to solve its capital recovery problem.<sup>3</sup>

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<sup>2</sup> "Simplification of the Depreciation Prescription Process", *Report & Order*, CC Docket No. 92-296, released October 20, 1993.

<sup>3</sup> Local exchange carriers (LECs) have not been given flexibility in setting depreciation rates. As a result, many LECs were required to share earnings under the original interstate price-cap plan — even though their *economic* earnings (net of economic depreciation) were far from excessive.

**Table 1**  
**AT&T's Depreciation Practices**  
**1984 - 1994**

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
<b>Regulated Books</b> <b>(Dollars in Millions)</b>											
<b>Gross Investment (TPIS)</b>	\$18,617.6	\$20,112.2	\$21,967.6	\$23,715.1	\$24,016.6	\$24,555.5	\$22,116.2	\$21,423.5	\$22,175.6	\$23,069.5	\$24,499.6
<b>Net Investment</b>	\$13,723.6	\$14,058.2	\$14,773.7	\$15,372.4	\$16,262.8	\$16,135.2	\$15,818.5	\$15,148.6	\$16,175.8	\$16,130.9	\$15,672.3
<b>Net Income</b>	\$607.1	\$974.6	\$1,307.4	\$1,472.8	\$1,689.0	\$1,946.7	\$2,197.2	\$1,905.9	\$2,116.3	\$2,384.7	\$3,272.9
<b>Rate of Return</b>	4.4%	6.9%	8.8%	9.6%	10.4%	12.1%	13.9%	12.6%	13.1%	14.8%	20.9%
<b>Depreciation Expense</b>	\$1,148.4	\$1,661.1	\$1,790.0	\$2,028.6	\$2,267.1	\$3,131.6	\$2,822.8	\$3,023.3	\$2,177.1	\$2,203.4	\$2,672.7
<b>Depreciation Rate<sup>a</sup></b>		8.6%	8.5%	8.9%	9.5%	12.9%	12.1%	13.9%	10.0%	9.7%	11.2%
<b>Extraordinary Items<sup>b</sup></b>	(2.7)	(8.5)	0.6	0.4	(0.7)	(0.2)			0.1		
<b>Financial Books</b> <b>(Dollars in Millions)</b>											
<b>Gross Investment (TPIS)</b>	\$38,507.8	\$39,184.0	\$39,888.0	\$39,682.0	\$40,900.0	\$40,830.0	\$38,529.0	\$39,892.0	\$40,050.0	\$43,295.0	\$45,982.0
<b>Depreciation Expense</b>	\$2,777.9	\$3,232.0	\$3,925.0	\$3,754.0	\$3,690.0	\$3,366.0	\$3,721.0	\$3,568.0	\$3,540.0	\$3,777.9 <sup>c</sup>	\$3,738.1 <sup>c</sup>
<b>Depreciation Rate<sup>a</sup></b>		8.3%	9.9%	9.4%	9.2%	8.2%	9.4%	9.1%	8.9%	9.1%	8.4%
<b>Extraordinary Items</b>			\$(175.0) <sup>d</sup>		\$(6,724.0) <sup>e</sup>		\$400.0 <sup>e</sup>			\$(9,617.0) <sup>f</sup>	

<sup>a</sup>Depreciation Rate is calculated by dividing Depreciation Expense by the average of Gross Investment in the current year and the preceding year.

<sup>b</sup>Extraordinary and Delayed Income Credits and Charges, and Net Income Tax Effect of Extraordinary Items.

<sup>c</sup>The 1994 10K does not break out Depreciation Expense from Depreciation and Licensing Cost Amortization. Therefore, we calculated the 1993 and 1994 figures for Depreciation Expense by taking the ratio of 1992 Depreciation Expense (as reported in the 1992 10K) as a percent of 1992 Depreciation and Licensing Cost Amortization (as reported in the 1994 10K) and multiplying by the total figures for 1993 and 1994, respectively.

<sup>d</sup>Cumulative Prior Years' Effect (to December 31, 1985) of a Change in Depreciation Method.

<sup>e</sup>Accelerated Digitization Program Costs.

<sup>f</sup>Cumulative Effects on Prior Years of Accounting Changes (Postretirement and Postemployment Benefits, and Income Taxes) of (\$9,608.0) and Loss on Sale of Stock by Subsidiary of \$9.0 (millions of dollars).

Source: Regulated Books: Federal Communications Commission, *Statistics of Communications Common Carriers*, for Years ended December 31, 1984 - 1994, 1984 - 1987 Editions and 1988/1989 - 1994/1995 Editions.

Financial Books: Securities and Exchange Commission, Form 10-K Annual Reports for AT&T, Fiscal years ended December 31, 1984 - 1994.